

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Pescetti Analyst: LuAnna Hass Bill Number: AB 1631
Related Bills: See Legislative History Telephone: 845-7478 Introduced Date: 02-23-2001
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: California Medical Savings Account Contributions Credit & Deduction

SUMMARY

This bill would allow both a credit and a deduction for any contributions made to a California medical savings account (MSA).

PURPOSE OF THE BILL

It appears that the intent of this bill is to create an incentive for taxpayers to save for future medical expenses by participating in a California MSA.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, "Archer MSAs" are trusts organized for the sole purpose of paying qualified medical expenses of the account holder, their spouse, and any dependent, as defined for income tax purposes, of the account holder. MSA's are available to individuals that are covered under a health plan that has a high deductible and is either a small-employer-sponsored health plan or a health plan for self-employed individuals. An individual is not eligible for an MSA if they are covered under any other health plan, unless the other coverage is permitted insurance or coverage for accidents, disability, dental, vision, or long-term care. Permitted insurance includes coverage for liabilities under worker's compensation, torts, ownership and use of property (automobiles), insurance for a specialized disease, or insurance providing a fixed payment for hospitalization.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

05/25/01

Under the federal pilot program that began in 1997, contributions to an MSA are deductible as an adjustment to gross income if made by an eligible individual or excludable from gross income if made by the employer of an eligible individual on behalf of that individual. However, an employee cannot have a deduction in the same year as the employer's exclusion. Earnings on amounts in an MSA are not taxable prior to distribution, and distributions from an MSA for qualifying medical expenses are not taxable. Withdrawals for non-medical expenses are taxable and subject to a 15% penalty. If an individual makes a withdrawal for non-medical purposes and is either 65, becomes disabled, or dies, the 15% penalty does not apply.

Generally, under this federal pilot program, the MSA deduction/exclusions are limited to a maximum of 750,000 taxpayers. Previously uninsured individuals are not taken into consideration in determining whether the cap is reached. After December 31, 2000, generally, no new contributions could be made to MSAs except for those who were participating in the pilot program.

California law conforms to the federal law on MSAs. However, withdrawals for non-medical expenses are subject to a 10% state penalty rather than the 15% federal penalty.

Existing federal and state law allows individuals to deduct certain expenses, such as medical expenses (which must exceed 7.5% of AGI), charitable contributions, interest, and taxes, as itemized deductions. Expenses for the production of income and certain employee business expenses are considered miscellaneous itemized deductions and must exceed 2% of adjusted gross income (AGI) to be deducted.

THIS BILL

This bill would allow a credit equal to any contribution made during a taxable year by a taxpayer to a California MSA. Any unused credit may be carried over until exhausted.

This bill also would allow a deduction equal to the total amount paid by an eligible individual during a taxable year to a California MSA. The deduction allowed by this bill would be an itemized deduction, and since the bill does not provide otherwise, the deduction would be subject to the 2% limitation applicable to miscellaneous itemized deductions.

For the deduction, "eligible individual" would be defined as any individual in this State. "California MSA" would be defined as a trust established according to provisions similar to the current federal law relating to MSA's.

IMPLEMENTATION CONSIDERATIONS

This bill uses a phrase that is not clearly defined, i.e., "California MSA." It is unclear which provisions of federal law relating to MSA's are to be applicable to a California MSA. In addition, the definition of "eligible individual" as an individual in this state needs clarification. Furthermore, the credit is equal to 100% of the "contributions" made to a California MSA pursuant to the deduction for cash paid to a California MSA. The deduction provision does not identify the amount paid as a "contribution." Although uncertain, it's presumed that the contributions for which a credit is allowed is equal to the amount paid for which a deduction also is allowed. The absence of definitions or other clarifications of these terms make implementation of this bill extremely difficult.

LEGISLATIVE HISTORY

SB 38 (Lockyer, Stats. 96, Ch. 954) conformed state law to the federal MSA law enacted in 1996. AB 2335 (Poochigian, 1997/98) would have made various changes to the existing MSA provisions, including a deduction for an individual's contributions to a California MSA. This bill failed passage in the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Review of *Illinois, Michigan, Massachusetts, Minnesota, and New York* income tax laws found a comparable deduction that conforms to the federal deduction for MSAs for each state except Massachusetts. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Tax Revenue Estimate

The revenue impact for this bill will be determined by the number of taxpayers who contributed to a California medical savings account, the amount of contributions, the average marginal tax rate applicable to the deduction amounts and the amount of credits that can be applied against available tax liabilities.

It is projected that as an order of magnitude, revenue losses could amount to \$16 million annually.

Under current law, taxpayers contributing to an Archer Medical Savings Account (MSA) can deduct between 65% and 75% of the contribution amount, depending on their filing status and the annual deductible of their health plan.

It is unknown in advance how many taxpayers would elect to contribute to a California Medical Savings Account under this proposal and it's unclear as to the definition of "similar to Section 220(d)(1)". Therefore, this estimate is an order of magnitude only. Based on the current MSA program, there were 3,749 taxpayers claiming total contributions of \$9.3 million, or an average contribution of \$2,500 for tax year 1999. It is assumed that the average contribution was 70% of the total contribution amount. This number was grown by CPI projections, yielding 4,019 taxpayers with an average contribution amount of \$2,500, or 70% of the total contributions for tax year 2001 (i.e. \$3,575).

Because of the incentive effect of this bill allowing a 100% deduction and credit, as an order of magnitude, if (1) twice the number of current MSA contributors established a California medical savings account in any given year (8,000), (2) applying an average deduction and credit amount of \$3,575, (3) assuming an average marginal tax rate of 6% on the deductions and a 50% credit usage rate in any given year, the revenue loss would be on the order of \$16 million annually. The revenue loss would increase in subsequent years due to carryover credits.

ARGUMENTS/POLICY CONCERNS

This bill would allow taxpayers to claim multiple special tax benefits for the same item of expense, by allowing a deduction and a credit for a California MSA contribution.

The credit would be allowed to any "taxpayer" who makes contributions to a California MSA under the Personal Income Tax Law (PITL). Thus, a business entity that is a taxpayer under the PITL i.e., sole proprietorship, partnership, or shareholder of an S corporation could claim the credit. However, a corporate taxpayer making contributions for its employees would not be eligible for the credit, creating an inequitable situation and discriminating against business entities based on their classification.

This bill does not specify a repeal date or limit the number of years for the carryover period. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. However, even if a repeal date were added, the department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

Credits generally are provided as a percentage of amounts paid or incurred. This bill would allow a 100% credit, which is unprecedented.

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